

scheme that bases an IXC's share of *regional* access costs upon its *national* share of the long distance market will clearly inure to the extreme benefit of the RBHC and to the disadvantage of its national competitors.¹⁶

The solution to the need both for immediate revisions as well as comprehensive reform is to design a reform process that is sufficiently well-organized and structured at the outset that changes can be introduced transitionally while still progressing toward a singular end-state result. The Ad Hoc Committee believes that such an approach is both possible and practical, and to that end has outlined a specific proposal and plan here.

III. A Balanced and Orderly Transition

Reform of the access environment must be accomplished in a manner that will foster, rather than impede, competition. By providing an environment which encourages development of new and innovative services at prices approaching costs, a competitive marketplace best serves the interests of consumers of telecommunications services. This Commission has taken a number of initiatives to expand interconnection opportunities, to foster competition in the provision of exchange access services, and to promote the development of competing local exchange networks.¹⁷ The challenge is to design a system that will support this vision while resolving tensions among various stakeholders. Achieving this result will require commitment, imagination, and will.

15. (...continued)
the Operating Companies' business.

(3) Service Circuits comprise a network of largely dedicated voice lines used to receive repair calls and directory assistance calls from Operating Company customers. These communications ensure the maintenance of telephone service and they provide directory assistance to Operating Company customers.

(4) Voice communications are used by the Operating Companies for hundreds of thousands of calls relating to their internal businesses.

16. For example, NYNEX could amass a 50% share of the in-region long distance market while maintaining only a 5% share of the national market. Under the NYNEX waiver proposal, its imputed share of the NTS access revenue requirement would be heavily influenced by its small national market share, and the Company would be responsible for considerably less than its 50% share of the long distance market within its own operating areas.

17. See, Expanded Interconnection with Local Telephone Company Facilities, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369 (1992); Expanded Interconnection with Local Telephone Company Facilities, Second Further Notice of Proposed Rulemaking, 7 FCC Rcd 7740 (1992); Expanded Interconnection with Local Telephone Company Facilities, Second Report and Order and Third Notice of Proposed Rulemaking, FCC 93-379, released September 2, 1993, in CC Docket No. 91-141.

Why access reform now?

Although it may seem like an obvious question, any serious examination of access charge reform ought to start by asking — and answering — the question, "why fundamental access reform now?" In the past, the Ad Hoc Committee has argued that a single, global reform proceeding was inappropriate. As recently as September, 1993, in Comments filed with this Commission in response to an FCC Staff White Paper on Access Reform,¹⁸ the Ad Hoc Committee proposed that the Commission not institute a comprehensive proceeding, but rather first focus on jurisdictional separations reform.¹⁹ At that time, the Committee also cautioned that precipitous restructuring of the present system could create unnecessary disruptions and uncertainties, which might in turn stimulate highly inefficient responses by interexchange carriers, end users, and competitive access providers. Our present proposal to begin a comprehensive proceeding is predicated upon a number of changes to the existing environment that have arisen (or become more significant) since last Fall. It is our belief that the time for addressing issues on a piecemeal basis is past: Now is the time to begin the more painstaking task of fundamental reform of *all* of the piece parts.

Steps have been taken towards eliminating a number of physical barriers to competition in the access and local service markets (i.e., through the restructuring of switched access local transport charges and the interconnection requirements). Although a number of barriers remain,²⁰ it is necessary to now begin the second step — reform of the underlying cost attribution and pricing rules. The existing rules could potentially penalize competitors while at the same time keep overall prices higher than they should otherwise be. Traffic-sensitive pricing of non-traffic sensitive costs sends out incorrect pricing signals are likely to inhibit the development of competition in those areas of the market in which competition may in fact be most viable.

The fundamental importance of the evolving changes in the access and local service markets is evidenced by the fact that virtually every major constituency has petitioned the Commission to begin investigating some major segment of the system, and the FCC has recently begun some related investigations on its own. 1993 saw petitions for rulemakings

18. Federal Perspectives on Access Charge Reform, A Working Staff Analysis, April 30, 1993.

19. See Comments of the Adhoc Telecommunications Users Committee filed September 23, 1993, p. 21.

20. Remaining barriers include, *inter alia*, prevailing subsidies of LEC-provided local services, LEC access charges imposed upon competitors both for originating and for terminating calls involving LEC facilities, local number portability, LEC control of telephone directories and directory data bases, LEC ownership of poles and conduits and LEC rights to condemn rights-of-way that prevail in many states (which rights are not available to competing local service providers), unbundling of service components, preemptive access to existing subscriber base, etc.

filed by the National Association of Regulatory Utility Commissioners (NARUC), the United States Telecommunications Association (USTA), and Metropolitan Fiber Systems (MFS). Proposals for alternative pricing or structural rules were advanced by Rochester Telephone, Ameritech and NYNEX. Activity has not slowed in 1994, with proposals for the reform of the Universal Service Rules being put forth by MCI and Teleport. The interrelationships between all of the various facets of the Access Charge System make it imperative that these various proposals not be evaluated in isolation.

While not all parties may agree with our prescriptions for comprehensive access reform, we nevertheless believe that we are offering a logical sequence for initiating the access reform process. The Committee proposes that the Commission first focus upon jurisdictional separations reform and upon eliminating remaining inefficiencies (i.e., non-cost based recovery methods) found in the access charge rules, while ensuring that adequate mechanisms for support of universal service objectives are maintained. Major access reform issues relative to pricing flexibility can begin to be addressed, but full pricing flexibility should await separations and basic access efficiency reforms, and should be timed to relate to the emergence of effective competition for specific access services.²¹ It should be noted that we are aware that the order in which we are suggesting the Commission address access reform is quite different from that desired by the LECs. However, since the LECs have yet to demonstrate that the full range of pricing flexibility that is available to them today (i.e., pricing flexibility bands under price caps, and zone density pricing) has been exhausted, it is premature to consider granting yet more flexibility.

Overall goals for access reform

The overall goal of the reform of the Access Charge System should be a more cost-based access pricing environment. Such an environment is likely to lead to lower usage-based switched access service prices and more competitive service alternatives. However, the movement towards lower, more cost-based access prices must not occur in a manner that inappropriately disadvantages competitors.²² Cost-based pricing should lead to

21. The Committee can envision the possibility that circumstances could develop under which changes in the competitive environment might justify discrete pricing flexibility rule revisions pending completion of the initial separations and access-charge-efficiency reform stages proposed herein. However, unlike the Commission's recent decisions implementing Zone Density Pricing, these should be limited to affording degrees of pricing flexibility directly commensurate with actual levels of competition.

22. Ostensibly cost-based strategic pricing initiatives by the LECs could actually undermine competition. For example, elimination of distance-sensitivity in switched transport rates, or large decreases in usage-sensitive rate elements, could shift demand away from dedicated services offered by CAPs and onto switched access services offered by LECs. To the extent that such revisions are not cost-based, their effect would be,
(continued...)

increased utilization of the public switched network, thereby fostering overall growth in the economy and correspondingly, the stimulation of jobs across the nation.

The access charge structure should be reformed to correct inefficiencies and recognize the need for changes in support mechanisms required to ensure universal service as the market for local exchange services undergoes a transition from a monopoly to a competitive market. LECs must be allowed to compete, and should be accorded pricing flexibility, but only to the extent warranted by achieved levels of access competition. However, while eventual displacement of the existing regulated model for provision of exchange access services by a market-driven model may be generally accepted as the desired end result towards which competitive and related access reform initiatives should point, *the more difficult question is how best to get from here (an access market featuring limited niche competition) to there (effective competition)*, assuming that we ever get there at all.

In the discussion that follows, we review the background of the existing access charge system and offer a specific strategy for improving the efficiency with which interexchange carriers and their customers compensate LECs for the costs of providing access services. We believe that reform of the present system can improve the overall efficiency of the nation's telecommunications infrastructure and market. Certainly, the access charge structure should adapt to changing market circumstances; at the same time, however, it should be kept in mind that the long distance market has performed well under the present access charge arrangement. Refinements and extensions to the basic structure have been underway for a number of years, and additional initiatives are currently under examination. None of these efforts should be postponed or held hostage during the comprehensive access reform. Rather, access reform should be viewed as an evolutionary process that can guide ongoing FCC and state policies and programs, leading to expanded interconnection, open network architecture, and broader competition at all levels of the network services market.

22. (...continued)

for example, to eliminate the *apparent* economic benefit to IXC's of maintaining multiple points of presence within the same LATA, thereby shifting POP-to-POP type traffic that is presently transported over dedicated facilities (frequently furnished by CAPs) onto LEC switched access/transport services. Compounding this effect, proposals that would eliminate some of the traffic-sensitive "separations" excess from per-minute access charges and load them into rate elements that would be paid by LEC competitors are similarly anticompetitive. For example, the so-called "Residual Interconnection Charge" ("RIC") effectively nullifies the adoption of cost-based transport charges by imposing *mandatory* payment obligations upon the IXC's irrespective of the manner in which they configure their access service arrangements. While the concept of the RIC may be acceptable as a *transitional* mechanism, it is clearly inappropriate to continue to collect LEC local transport revenue requirements from customers of CAP transport services simply because those services interconnect with the LEC switching network over the long term.

Our proposal here is not for a "precipitous" change in the access environment, but rather for a reasoned and well-thought-out set of replacements to the rules that are in place today. In some cases, the changes may be implemented immediately; in others, they may need to be phased in over time as conditions warrant. In all cases, however, the preservation of a single uniform set of access charge, universal service and separations rules is of paramount importance.

IV. History of the Existing Access Charges

The present system of "access charges" was adopted by the FCC in 1983 following a five-year-long investigation in CC Docket No. 78-72 that was initiated to examine the MTS/WATS "market structure."²³ As we have noted, the immediate need for that proceeding was occasioned by the 1977 decision of the United States Court of Appeals for the District of Columbia Circuit upholding MCI's right to provide switched long distance telecommunications services in competition with AT&T.²⁴ By 1979, a rudimentary access charge scheme known as "ENFIA" (for *Entrance Facilities for Interstate Access*) was in place. ENFIA imposed a flat monthly rate for each trunk used by an "Other Common Carrier" ("OCC") (the term used to describe interexchange carriers (IXCs) other than AT&T) to interconnect to the local public switched network. Initially, ENFIA trunks were physically indistinguishable from ordinary business PBX trunks; they provided "line-side" connections to class 5 end offices and were assigned ordinary 7-digit "POTS" type telephone numbers. As such, users of OCC services were required to dial the 7-digit access number, followed by a multiple-digit Personal Identification Number (PIN) code, and finally the 10-digit number they were calling. The OCCs did not receive answer supervision signals over these access facilities, and hence were forced to adopt far less reliable surrogate devices for billing purposes.²⁵ All in all, the arrangement was far from satisfactory, and the OCCs persisted in their efforts to obtain the same type of 1+ access as was (at that time) available solely to AT&T.

23. MTS and WATS Market Structure, Third Report and Order, 93 FCC 2d 241 (1983), aff'd in principal part and remanded in part, National Ass'n of Regulatory Util. Comm'rs v. FCC, 737 F.2d 1095 (D.C. Cir. 1984), cert. denied, 469 U.S. 1227 (1985).

24. MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir.), cert. denied, 434 U.S. 1040 (1977); see also, MCI Telecommunications Corp. v. FCC, 580 F.2d 590 (D.C. Cir.), cert. denied, 439 U.S. 980 (1978).

25. One commonly used technique was to consider the call to have been answered after a fixed number of seconds following the completion of dialing. As a result, customers were sometimes charged for no-answer calls (where they did not hang up soon enough) and on occasion were not charged for very short calls that were answered but quickly terminated.

On the other hand, the ENFIA arrangement afforded OCCs an enormous "discount" relative to the access fee implicitly included in AT&T's interstate long distance MTS tariff charges. The monthly flat rate for an ENFIA trunk was based upon 9,000 minutes of use but in practice the OCCs were often able to achieve higher traffic loads, and as a result, lower the effective charge per minute of use ("MOU"). By contrast, the then-existing AT&T MTS rates provided a per-minute contribution of approximately 18 cents to the interstate-assigned non-traffic-sensitive cost of the subscriber line, or 9 cents per originating or terminating MOU. The effective discount provided to the OCCs through the ENFIA per-trunk charge was approximately 70%.

On January 8, 1982, the settlement of the government's 1974 antitrust case against AT&T was announced in a document that has since become known as the "Modification of Final Judgment" ("MFJ").²⁶ Although moving along an entirely separate track from the FCC's market structure docket, the MFJ contained several key provisions that would have a decisive impact upon the further direction and ultimate outcome of Docket 78-72. Specifically, the MFJ required that:

- AT&T and the BOCs be separated, that AT&T would furnish interexchange services, and that the BOCs would be restricted to furnishing services within defined "Local Access and Transport Areas" (LATAs);
- AT&T and other IXC's would be provided access services by the BOCs at cost-based prices; and that
- The BOCs would be required to provide, after an appropriate transition, the same type and quality of access services to the "OCCs" (i.e., the non-AT&T IXC's) as they had been providing to AT&T (the "equal access" requirement).

Implementation of the divestiture was set for January 1, 1984, a schedule that effectively forced the adoption of a workable switched access charge system by that date. The initial switched access charge scheme was completed in time, and included the following key features:

- Recovery of "traffic-sensitive" ("TS") access costs (primarily local end office switching and interoffice switching and transport) on a per-minute-of-use and/or per-minute/mile basis;
- Recovery of "non-traffic-sensitive" ("NTS") access costs through a combination of fixed "end user" charges (the "Subscriber Line Charge" ("SLC")) and usage-based,

26. United States v. AT&T, 552 F. Supp. 131 (D.D.C. 1982), aff'd sub nom., Maryland v. United States, 460 U.S. 1001 (1983).

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per-MOU charges (the "Carrier Common Line Charge" ("CCLC")) imposed upon IXC customers;

- Equal charge per minute of use irrespective of the method of access service routing (direct or via an access tandem) employed by the IXC;
- Establishment of a transition plan whereby the SLC would be increased and offset by decreases in the CCLC, along with a "true-up" mechanism to further decrease the per-minute CCLC to account for growth in the overall volume of switched access usage;
- The requirement that AT&T flow-through in its MTS rates all decreases in the per-MOU CCLC relative to the pre-access charge implicit NTS support as well as the periodic transition and true-up decreases in the CCLC; and,
- A transition plan for "equal access" under which OCCs would be afforded "non-premium" discounted access charges in each central office until full "equal access" became available in that office.

The introduction of the SLC, coupled with the mandatory flow-through of reductions in per-minute NTS payments, had the effect of rebalancing the relationship between fixed monthly end user rates and usage-sensitive revenues. The consequence of this policy was to increase the total monthly charge (including both the state-regulated and interstate components) while reducing the usage-based charges for interstate toll calls. The maximum residential SLC was eventually (in 1989) set at \$3.50 per month after a multi-year transition under which no single increase exceeded \$1.00, and the maximum business SLC was set at \$6.00 per month. In some cases, the actual SLCs were set below these limits, if (for a specific company/jurisdiction) the per-line interstate-assigned NTS was less than the maximum.

All NTS costs assigned by separations to the interstate jurisdiction that are not recovered through the SLC are recovered through the CCLC. The CCLC provides both a general contribution mechanism (to support below-cost pricing of basic residential access) as well as explicit "assistance" for extraordinarily high-cost exchanges (the Universal Service Fund) and for low-income customers requiring targeted support for installation and recurring fixed monthly exchange access charges (Lifeline and Link-Up programs). Among other things, the CCLC process also creates subsidy flows going from relatively low-cost jurisdictions (in which, for example, the SLC is sufficient to recover all interstate-assigned NTS costs) to jurisdictions characterized by above-average costs, because the very same interstate CCLC is applied uniformly throughout each RBOC region *irrespective of the extent to which the SLC recovers NTS costs in each individual jurisdiction and/or BOC.*

The Commission's rate rebalancing policy has produced numerous and important benefits to the telecommunications industry and to the economy in general. Retail MTS rates have decreased by approximately 40% from their pre-divestiture, pre-access charge levels. Moreover, the growth of MTS competition has resulted in the introduction of numerous volume-based pricing plans for business and residential subscribers, making the *effective* decrease in MTS rate levels far greater than the nominal 40% drop in the "rack rate." Total switched network usage has approximately tripled since 1983²⁷ and, despite the fears of some that the imposition of the SLC might drive residential subscribers off the public network, no such "drop-off" has been observed and, if anything, residential penetration rates are higher today than they were in 1983.²⁸

V. Universal Service Funding

The costs incident to furnishing basic local telephone access ("loops" or "dial tone lines") are subject to considerable variation from place to place, due to such factors as size and density of population, geographic characteristics of the area served, and rate of growth in the indigenous population, among others. Prior to the adoption of access charges, these disparate cost conditions were broadly averaged through several revenue sharing mechanisms, principal among which were "jurisdictional cost separations," "division of revenues plan" within the Bell System, and "settlements" among non-affiliated local and long distance operating companies. The introduction of explicit, service-based access charges largely replaced the division of revenues and settlements mechanisms, but in the process had the effect of eliminating much of the pre-divestiture implicit and explicit cost sharing that had prevailed in the telephone industry. The replacement for these devices was the so-called "Universal Service Funding" mechanism through which high-cost exchanges receive support from the balance of the customer base. In addition to such *exchange-level* subsidization, these new mechanisms also addressed an aspect of universal service that had been largely ignored by the preexisting systems — support for *low-income subscribers* to ensure that they remain connected to the public switched network.

27. From the third quarter of 1984 to the first quarter of 1993, total interstate switched access minutes increased from 37.5 billion to 90.1 billion. Long Distance Market Shares, Federal Communications Commission, Industry Analysis Division, June 1993 Edition, p. 7. Moreover, this "straight" count of switched access minute growth actually understates the growth of switched network traffic over this period because the 1983 access minute counts were taken prior to the direct assignment of WATS. Consequently, they included usage originating or terminating over dedicated access facilities. The 1993 access minute counts do not include usage originating or terminating over dedicated access facilities and, therefore, are not as fully representative of total switched network traffic.

28. In November of 1992, 93.8% of U.S. households had telephone service. This compares to 91.4% in November of 1983. Monitoring Report, Staff of the Federal-State Joint Board, May 1993, p. 15.

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Perpetuation of some device for accomplishing both of these results must be a key component of any reform of the access charge system. The universal service funding requirements and rules will necessarily impact virtually all stakeholders. Accordingly, it is essential that any new funding scheme be designed so as to be as neutral in its effects upon demand and competition as possible.

The Communications Act of 1934 first expressed the public policy objective of universal service, stating that the goal of the Act is to "... make available...to all people of the United States a rapid, efficient, Nation-wide and world-wide wire and radio communications service with adequate facilities at reasonable charges ..."²⁹ By any reasonable measure, this goal has for all intents and purposes been achieved. By November, 1992, 93.8% of households in the United States had telephone service.³⁰ This result was achieved despite earlier fears (often expressed in the aftermath of the divestiture and in connection with rate rebalancing programs at both the federal and state levels) that increases in the basic monthly residential service price would result in a significant "drop off" in connectivity to the public telephone network. That, of course, did not occur. Now, faced with the possibility of competition in the provision of local exchange access, new concerns are being expressed that "universality" is once again threatened, but not quite in the same manner as it was supposed to have been undermined by prior telecommunications policy.

Up until now, the concept of "Universal Service" was defined very narrowly, and was largely limited to *access* to the public network. From time to time, the basic public network platform that was embraced by the "universal service" definition has been expanded or modified; for example, dial telephones replaced manual switchboards, direct distance dialing was introduced, in several states tone dialing has replaced rotary "pulse" dialing, and in most jurisdictions one-party service has become the "standard," replacing "party lines."³¹ In some respects, the scope of "universal service" has actually narrowed: For example, basic local telephone access no longer includes a "main" telephone instrument, inside wiring, or "free" use of Directory Assistance service. Some of these changes were introduced on a "flash-cut" basis (e.g., elimination of the primary telephone instrument); for others, the process required a lengthy transition. For example, for most of the period that touch tone dialing has been in existence (since the mid-1960s), and in

29. The Communications Act of 1934, Title I, Sec. 1.

30. Monitoring Report, CC Docket No. 87-339, May 1993, Prepared by the Staff of the Federal-State Joint Board In CC Docket No. 80-286, at 12.

31. For a discussion of the evolution of the basic service platform, see Selwyn, Lee L., "Efficient Infrastructure Development and the Local Telephone Company's Role in a Competitive Industry Environment" *Presented at the Twentyfourth Annual Conference of the Michigan State University Institute of Public Utilities*, Williamsburg, VA December 14, 1992.

most jurisdictions today, LECs impose a premium charge for this feature. However, several states have recently redefined "basic service" to include tone dialing as a standard feature.³²

The emergence of new technologies and a vast array of new telecommunications applications has opened a new debate over the scope of universal service. Among other things, some have argued that the definition of "universal service" should be expanded beyond the goal of making "basic dial tone" universally available.³³ Policymakers will be asked to consider whether the universal service definition should mean "cheap" basic dial tone for all, broadband for all, or something in between. The answers to these questions could have a profound impact upon how and if competition develops in the local service markets. For this reason, a universal service policy for an increasingly competitive environment should:

- create a mechanism for determining *and for delimiting* where subsidies should be applied;
- establish how much of a subsidy is appropriate for each situation;
- determine how the subsidy will be funded; and
- establish a mechanism for impartially administering the collection and distribution of such subsidies.

The role of subsidy and assistance mechanisms in a reformed access charge structure should be kept to the minimum necessary to efficiently accomplish public policy goals. These mechanisms should be designed such that they cannot be employed to provide protection to LECs from competitive incursions and loss of market share, or support LEC investment programs that cannot otherwise survive a market test.

32. For example, the California PUC took this initiative in 1989. 33 CPUC 2d, 43, 117. However, for the most part, touch tone is still subject to a surcharge, residential surcharges typically range from approximately \$0.75 to as much as \$2.00 per month, business single line and PBX trunk surcharges can be twice as high.

33. Proposals to revise the Universal Service Funding mechanisms (and incorporating discussions of the universal service definition) have been put forth by USTA, MFS, MCI and Teleport.

The universal service obligation: burden or benefit?

Universal service, as this term is understood today, tends to mean basic *analog voice grade* "dial tone line" access capable of supporting voice and low speed data communication to all subscribers and capable of being furnished via twisted copper pairs. The obligation to provide universal service has been portrayed by LECs as a net *burden*, the costs of which *must be shared by competitors*. There may, however, be positive economic benefits available to the LECs that flow from being the Universal Service provider which tend to reduce — or perhaps even eradicate — the alleged "burden." Such benefits could include economics of integration and scope that might be partially lost if service was not provided ubiquitously. Such ubiquity confers enormous strategic and competitive advantages on the LECs that are not available to or shared by non-dominant rivals.³⁴

The growing interest in the so-called "information superhighway" and the "National Information Infrastructure" has raised concerns about the implications of excluding segments of the population from these new resources, a condition that (arguably) may obtain if the existing basic service platform is not itself enhanced so as to support the broadband character of "superhighway" type services. On the other hand, many have argued that the extremely high costs of acquiring a nationwide broadband network — costs that could approach a quarter trillion dollars³⁵ — should be borne by *users* of these new broadband services and not by the entire population generally. This tension between those advocating massive new investments and commensurate enhancement of the scope of basic service, on the one hand, and those who insist that consumers who do not desire the new services should not be forced to pay for their acquisition, will need to be resolved. Ideally, it should be resolved by the marketplace itself: If there is demand sufficient to justify the massive investment, then the costs will be covered by those who voluntarily purchase and pay for the new services. On the other hand, if the investment is made

34. For example, LECs are able to furnish competitive services such as Centrex by utilizing outside plant facilities that are shared with basic business and residential "POTS" access lines. As such, they and they alone can offer Centrex-like services without being required to incur outside plant investment costs on a stand-alone basis. Similarly, LECs can compete with specialized Competitive Access Providers utilizing joint plant that carries both special access, "POTS," and other LEC services, whereas the CAP must necessarily recover the entire costs of its plant from the far more limited special access market segment.

35. In November, Pacific Bell announced its plans to invest \$16-billion over the next seven years to deploy broadband services to some 5.5-million customers. See *In re matter of the Application of Pacific Bell* (W-P-C 6913, 6914, 6915 & 6916), for the authority pursuant to Section 214 of the Communications Act of 1934, and Section 63.01 of the Commission's Rules and Regulations to construct and maintain advanced telecommunications facilities to provide video dialtone services to selected communities in Los Angeles, San Francisco/San Jose, Orange County and San Diego, California. That works out to about \$2,900 per customer. Extrapolating that to the roughly 130-million US residential and business access lines, the national investment could actually top \$300-billion.

through unilateral LEC initiative and sanctioned by regulatory acquiescence, then individual customers could be forced to bear the costs whether they want or need the new capabilities.

The Ad Hoc Committee cannot overemphasize its belief that acquisition of new network resources should be driven by demand (and not by government sanction or fiat) and accomplished through a fully competitive process (and not through unilateral diversions of monopoly services revenues by dominant LECs).

Expansion of the prevailing universal service concept should occur through evolution, based upon actual and demonstrated demand. Despite the hype and rhetoric about information superhighways, there is no persuasive evidence that the general public actually wants additional two-way communications services and is willing to pay the additional costs of acquiring these capabilities at this time. The Committee urges the Commission to develop threshold tests of the demand for network technologies (and the willingness of the general body of ratepayers to pay for such technologies) before expanding the definition of universal service.

A zero-base approach

The existing subsidy system consists of both explicit subsidies in the form of assistance programs and an implicit subsidy in the form of subsidies to residential service from other LEC services.³⁶ Three explicit subsidy programs exist pursuant to FCC rules:

- the Universal Service Fund (USF);
- the Lifeline Connection Fund; and
- the Common Line Pool.

The USF subsidizes high cost LECs, while the Lifeline Connection Fund compensates LECs for waiving connection charges for low-income users. The Common Line Pool is funded by contributions from LECs from charges assessed on interexchange companies for access. The flow of funds in the pool is from large LECs to smaller LECs, in order to subsidize line costs. In addition to these *explicit* subsidy and assistance mechanisms, there are numerous *implicit* subsidy flows inherent in the overall telecommunications pricing system, in that certain services are priced well in excess of cost while others are priced so as to make no or minimal contribution to fixed overheads and common costs. In all, the

36. The issue of "implicit" subsidies is addressed in the discussion of separations reform.

LECs estimate these subsidies to local service (implicit and explicit) to be in the range of some \$20-billion per year.³⁷

Both the implicit and the explicit subsidy programs require review. On the one hand, it is inappropriate that only LEC services be subject to contribution obligations in support of explicit public interest goals, such as furthering the goal of universal service through high cost assistance. At the same time, it is equally inappropriate that the traditional structure of LEC costs and markets, including the inefficiencies in these structures, be imposed on competitor services through the need to conform to subsidy requirements.

An examination of certain of the assumptions underlying the existing system needs to be made in order to determine where subsidies should be applied and how much of a subsidy is appropriate. For example, it has been generally accepted that LECs required to furnish service in low-density exchanges, often involving large distances between the subscriber and the central office, encounter extraordinarily high costs. Advances in wireless technology, digital carrier systems and decentralized digital switching systems, along with other innovations, have fundamentally altered the manner in which service to such exchanges is furnished. While production conditions confronting rural exchanges are, and will continue to be, different from those in urban areas, the cost differential is likely to be far less in the future than it has been in the past.

A basic tenet of the long-standing policy of pricing basic residential exchange service below cost is concern that subscribers, faced with higher prices, will drop off the network.

However, studies undertaken both at the federal and state levels over the past decade have confirmed that the price elasticity of demand, for the vast majority of residential telephone customers, is virtually zero.³⁸ Universal residential penetration does not require that each and every residential subscriber be offered service the cost of which receives support from long distance toll revenues. Income-based targeted subsidies should in most instances prove sufficient. Experience has also demonstrated that the installation charge is frequently a far greater barrier to residential demand among low-income customers than relatively high monthly charges. In fact, since roughly 17% of Americans move each

37. It should be noted that many parties believe the LEC subsidy claims to be vastly overstated. See, for example, MCI's paper "From a Single Lane to the Superhighway: Rethinking Universal Service Policy for the 21st Century" (February, 1994), p. 2 and TCG's paper "Universal Service Assurance: A Concept for Fair Contribution and Equal Access to Subsidies (December, 1993), pp. 4 - 5.

38. See, De Fontenay, Alain, Mary Shugard and David Sibley, *Telecommunications Demand Modelling: An Integrated View*, Amsterdam: Elsevier Science Publishers B.V., 1990. See also, Taylor, Lester, *Telecommunications Demand: A Survey Critique*, Cambridge, MA, Ballinger Publishing Company, 1980. See also, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *AEA Papers and Proceedings*, Volume 83, No. 2, May, 1993.

year,³⁹ policies such as "Link-Up America" that target low-income customers at the time of service connection may be the most effective means of assuring universal connectivity.

The merits of prospective subsidy mechanisms should be addressed through a "zero-base" process. Under such an approach, affirmative justification would be required to support potential uses of subsidy flows generated through the access charge process. The Commission could also consider, as part of this process, alternative regulatory responses.

The Commission should explore mechanisms other than reimbursement of the incumbent LEC for providing service to high cost exchanges. Competitive bidding by prospective franchisees, or competitive provision of alternative services based upon multiple technological platforms, could be considered so as to assure the availability of services in bona fide high cost localities. The Commission should consider direct responses as an alternative to the passive subsidization mechanism which has been traditionally applied through access charge subsidy and assistance mechanisms to the extent it is demonstrated that specific low-density areas have high cost attributes.

One problem with the existing arrangement is that it fails to separate the source of the "high cost" from the attributes of the serving area itself and inefficiencies inherent in the non-competitive process through which such services are produced and provided. If competing local services providers are forced to contribute to the support of high cost exchanges, they may well be made to support and subsidize the very same inefficiencies against which they are attempting to compete. Rather than simply being required to contribute to support high cost LEC services, one solution to this problem is to allow competing firms to bid for the right to provide service at a lower cost to those same high cost customers or exchanges and to themselves draw subsidies for these undertakings. Such bids could include, among other things, the amount of fund support the bidder would require in order to offer service to the purportedly high cost area(s), as well as the price to be charged directly to customers in the subject exchange(s). This type of approach would work to eliminate inherent LEC inefficiencies by forcing the LECs themselves to exclude them from their own bids. If such an approach were adopted, industry participants and end users would be less likely to involuntarily support LEC inefficiencies in the provision of service to high cost areas.

In considering the need to subsidize basic residential exchange service, the Commission should seek information on the actual structure of demand for such services, the extent to which demand is a function of household income or other factors, and methods for segmenting the market so as to limit subsidies to only those sectors where the potential for drop-off is greatest. Here, too, the Commission could consider alternatives

39. Geographic Mobility: March 1990 to March 1991, United States Department of Commerce News, p. VII.

to passive subsidization. In the event that competition for the provision of local dial tone service develops, the responsibility for serving low-income customers for whom some type of assistance is necessary should be spread across the various providers (whether dominant or non-dominant) in proportion to their respective market shares or through some sort of competitive bidding process. As a general proposition, passive subsidization mechanisms should be considered as a "last resort" and, if used, should be limited to discrete instances of demonstrated need.

A zero-base approach will minimize economic distortions; that is, it will allow attention to be properly focused upon efficient pricing of access services without being encumbered by the need to inefficiently recover any consequential amount or cost from dominant carriers, competitive providers, and end users. Whatever contribution the Commission determines is required through the zero-base approach should be collected through a broad, uniformly-applied charge on all relevant industry participants.

One feature of the existing access charge rules is implicit support for a long-standing LEC practice of providing basic residential local exchange service at a below-cost monthly rate, with the shortfall to be made up through intrastate and interstate toll, access, and other charges. The FCC's Subscriber Line Charge was an effort to rebalance this assumed relationship, and to establish a closer linkage between interstate rates and costs. It would be entirely inappropriate for competing facilities-based providers of basic exchange service, whose pricing practices may bear little relationship to those of the LECs, to be subject to access charge rules that reflect subsidy mechanisms designed to support traditional LEC rate structures. In the long run, it is equally inappropriate for competing access providers to confront subsidized LEC monopoly pricing which can only chill competitive entry and innovation. Accordingly, any fundamental reform of access charges should limit non-LEC participation in subsidy and assistance mechanisms to those minimally necessary to support legitimate public interest goals, and should protect competitors from rules and practices that unduly favor LECs and/or disadvantage competitors. While we support legitimate public policy goals, it is inappropriate to implement or continue policy that purposely protects all existing LEC revenue streams.

It is inappropriate to designate a single competitor as the collector, guarantor and administrator of assistance funding where there is competition in loop, switching and transport in the local exchange market. A mechanism that cannot be used to the advantage of one competitor must be found to collect and distribute funds. For example, MFS Communications proposes that the Commission provide for a neutral third-party administrator for all subsidy programs.⁴⁰ The Ad Hoc Committee strongly supports this proposal.

40. Petition of MFS Communications Company, Inc. for a Notice of Inquiry and En Banc Hearing, Dated November 1, 1993, p. 17.

Affirmative proposals for reform of the universal service funding mechanisms

If competition in the local exchange access service markets is to develop, the current level and method of subsidizing residential service in high cost exchanges must be re-examined.

At the present time, only LECs may draw from the USF; in the future, non-LECs should be given the ability to "bid" on satisfying Universal Service goals, which could involve support from the funding mechanism.

- Before funds are distributed to assist with the provision of service in "high cost" exchanges, competing firms should be allowed to bid to provide service at a lower cost (thereby improving overall economic efficiency, and lowering the size of the overall fund). Mechanisms must be instituted to protect telephone subscribers in the event that an unqualified provider bids for and receives the right to receive subsidies. This could be accomplished by establishing minimum financial and technological qualifications for bidding, requirements for posting of surety bonds, and specific service standards that would have to be satisfied.
- Additionally, a "means" test should be developed to size and target any subsidy.

Until such time as there is demonstrated customer demand for an expanded definition of universal service that encompasses broadband applications, the funding for universal service should be based upon and limited to the existing definition of basic service.⁴¹ In its "Infrastructure Report" to the Governor of California, the California Public Utilities Commission specifically recommended such an approach.⁴²

41. MCI has proposed a somewhat similar approach in its paper entitled "From a Single Lane to the Superhighway: Rethinking Universal Service Policy for the 21st Century Consumer".

42. The following recommendations are found on page 48 in a report entitled *Enhancing California's Competitive Strength: A Strategy for Telecommunications Infrastructure*, released by the California Public Utilities Commission in November 1993 (emphasis added):

- [D]evelop a common, but technology-neutral, standard governing the minimum technical capabilities of basic digital access...
- Monitor deployment and usage patterns as competing firms deploy digital capability around the state. If geographic or other significant gaps occur and persist, consider the possibility of offering targeted subsidies to any competing firms willing to fill such gaps.
- *When a major portion of California's individual and business consumers find value in and use second-tier service, and digital access has become a common method for doing personal and commercial business, consider expanding Lifeline support to cover second tier digital service.*

- Infrastructure investment that is made to support "new" broadband interactive services (the demand for which is unknown at this time) as well as a more expansive vision of Universal Service should be made at shareholder risk if such investment is made prior to affirmative regulatory approval has been obtained. Price cap indices should not rise, or "productivity offsets" be decreased, to fund infrastructure development.⁴³
- Before the concept of Universal Service is expanded, a clear demonstration of need and demand should be required and the level and targeting of subsidy (if any) should be carefully considered by public officials. If the definition is expanded and residential consumers do not pay for that expansion the indirect subsidy to such consumers will increase and may be borne principally by business users. Alternatively, telcos could insist on lifting line of business restrictions to allow them to earn more vertical services revenue. Neither choice is attractive.
- Threshold tests of the demand for network technologies (and the willingness of the general body of ratepayers to pay for such technologies) should be developed and such thresholds should be met before expanding the definition of universal service.

The mechanism presently used for collecting the revenues that are ultimately contributed to the Universal Service Fund must be revised. Revenues should not be collected from interstate access service customers (i.e., IXC's) of the incumbent LECs as it is today, rather, all local service customers of *all* local service providers should be made to contribute. Today's system collects USF funds based upon an assessment against presubscribed local access lines. Rather, a new USF charge should be developed that would be assessed on the local service provider for each and every local loop (analog or digital) provided by that carrier on a voice-grade equivalent basis. The local service provider would then have the ability to collect the USF revenues it has paid from its access service subscribers. The present assessment to IXC's on presubscribed line basis could continue, but additional loops (i.e., special access loops and alternative provider loops) would also have the USF charge assessed against them, thereby lowering the USF contribution assessed against each presubscribed line. Necessarily, since USF revenues will now be collected from both LECs and their competitors, NECA can no longer

43. As the Ad Hoc Committee has observed in its Protests to Pacific Bell's Video Dial Tone ("VDT") Section 214 Applications, the Company is there seeking regulatory approval for only a small fraction of the total costs incident to constructing its proposed fiber/coax broadband network. Thus, if the FCC approves the spending proposed in these Applications, which the Committee believes it should not do, such approval should not be construed as running to the more than 95% of the total cost of this construction that is left unaddressed in the subject Applications. See Petitions of the Ad Hoc Telecommunications Users Committee to Deny Applications of Pacific Bell (W-P-C 6913, 6914, 6915, 6916), dated February 14, 1994.

administer the fund. USF revenues should be collected from (and distributed to) local service providers by a neutral third party.

VI. Separations Reform

Virtually every time that anyone attempts to change any piece of the Access Charge System they bump into the wall of *jurisdictional separations*. Everyone agrees that the present separations system needs to be fixed — but as of now no one seems to be able to agree on precisely how to fix it. The overall level of revenue requirement that is to be allocated by the separations process is directly affected by the scope and definition of universal service (as discussed above). The extent to which Part 69 access charge rules can be reformed (discussed below) is directly impacted by how the separation system allocates the revenue requirement to the federal and state jurisdictions. Separations reform is thus inseparable from access charge reform.⁴⁴

In terms of sequencing of issues to be examined, the first threshold policy area to be addressed in a comprehensive proceeding must necessarily be jurisdictional separations. Separations *drives* access policy, and no serious reexamination of the latter can take place without first moving towards resolving inefficiencies in the underlying process by which costs are assigned to and recovered from the respective state and federal jurisdictions. Because separations drives access costing and pricing today, access costs are not being recovered in an economically efficient manner. By extension, this means that the telecommunications network is not being used in the most economically efficient manner which in turn means that overall US productivity is not as great as it could be (thereby contributing to lower real wages and slower job growth). Clearly, the reform of the separations system is of paramount importance both to the telecommunications industry and the nation as a whole.

The problems inherent in the existing system can be divided into, and addressed through, two distinct areas:

- The *mechanism* used to allocate costs (revenue requirement) between the state and federal jurisdictions (and between traffic-sensitive and non-traffic-sensitive categories); and

44. Adding to the critical need for separations reform is the continuing movement of state regulators away from traditional rate regulation while at the same time allowing the LECs to pursue often massive infrastructure upgrade programs. In essence, state regulators are approving measures that will lead ultimately to an *interstate* price increase (through an increase in the overall investment and expense base to which separations factors are applied), while at the same time declining in large part to regulate how the additional investment is made and how the additional revenue requirement is to be recovered.

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- The overall *level* of revenue requirement being assigned to the interstate jurisdiction.

It is necessary to first fix the *mechanism* before proceeding to address questions relative to the overall *level* of revenue requirement assigned to the interstate jurisdiction.

Problems inherent in the separations mechanism

Most parties now recognize that current separations practices do not provide meaningful and accurate cost information for either the state or the interstate jurisdictions. Rather, the present jurisdictional cost assignment process has proven itself to be incapable of accurately reflecting the technical state of the network, unable to keep pace with technological advancements, and largely driven by revenue effects and pseudo-political goals. Existing separations procedures embody a number of allocation mechanisms that do not reflect the cost characteristics of the underlying investment, since network architecture has long failed to lend itself to simple classification. The distinction between traffic-sensitive and non-traffic-sensitive investment is no longer easily discerned and, as it is defined by the FCC's Part 36 Rules, has little real meaning.

By its very nature the separations process continues to address the symptoms rather than the problems, and the continuation of present cost assignment policies would serve only to perpetuate these practices. Attempts to remedy the process via discrete changes have been and will continue to be ineffective because they fail to recognize the fundamental inadequacies of the current jurisdictional separations process. Fine tuning an allocation factor that is arbitrarily defined and applied does little to lend accuracy or meaning to the results of the calculation.

A totally new, results-oriented approach to separations is called for. The present arbitrary NTS and TS allocation policies drive disparate and sometimes inconsistent state and federal pricing responses, and in any event bear little or no relationship to the objectives of achieving efficient pricing and efficient competition. These latter objectives should drive separations policy, not (as is the present situation) the other way around. In February and in April of 1992, the Ad Hoc Committee proposed to the NARUC Access Issues Work Group (AIWG) a specific results-oriented approach to separations that we termed the "Minimal Annual Revenue Transfer" ("MART") system. We have refined this earlier proposal to better reflect current and future technology and market conditions, which we now term the "Jurisdictional Transfer Mechanism" (JTM).

The JTM approach distinguishes the outmoded "cost" computational issues from the actual underlying policy objectives of the jurisdictional separations process itself. As a result, it offers a more efficient regulatory mechanism that will accelerate the development of a simpler and more rational system, one whose

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effects can be understood and predicted by the growing number of participants in the US telecommunications marketplace. In order to accomplish this result, jurisdictional separations should be approached from the standpoint of the desired policy goals, and viewed as a system of revenue transfers whose purpose is to support and to achieve those goals.

Existing non-traffic-sensitive cost assignment problems

In CC Docket 80-286, the Federal/State Joint Board established a policy whereby precisely 25% of all NTS costs would be assigned to the federal jurisdiction, and the remaining 75% would be assigned to the states. This "fixed" assignment, which was phased in over an eight-year period between 1986 and 1993, replaced the previous scheme under which NTS was assigned as a (weighted) function of relative jurisdictional usage levels.⁴⁵ Significantly, both the new uniform 25% allocation, as well as the previous usage-based scheme that it replaced, represent entirely arbitrary approaches to the jurisdictional assignment of NTS investment and expenses. In practice, approximately three-fourths of interstate-assigned NTS costs are currently being recovered through fixed monthly end user (SLC) charges, whereas a far lower percentage of state-assigned NTS costs is being recovered in this manner.⁴⁶ Thus, even if the CCLC were eliminated entirely at the federal level, in the aggregate a substantial portion of NTS costs would continue to be recovered through usage-based rate elements applied to local and intrastate toll services, and to intrastate switched access.

To be sure, a number of individual states have pursued rate rebalancing policies either modelled upon or otherwise analogous to the FCC's, and have shifted increasing proportions of intrastate revenues to fixed monthly rate elements. Nevertheless, such policies are far from uniform and can in some cases interfere with federal objectives. It is not known whether and to what extent the cost differences are attributable to local

45. See discussion of Federal-State Board action in CC Docket No. 80-286, *Federal-State Board Monitoring Report*, July 1992, Section 3.

46. The precise state NTS recovery breakdown is difficult to construct from available data. States have generally not adopted any explicit NTS-recovery element such as a SLC, relying instead on monthly local exchange service rates for flat or measured rate residence or business service. Some LECs have sought to unbundle the access line from usage, adopting the concept of a "dial tone line" to reflect a "pure" NTS rate element. An educated guess as to the extent of NTS recovery via fixed monthly rates at the state level is probably in the 40% to 50% range. NTS cost and recovery policies vary across the country. See Comments of the Ad Hoc Telecommunications Committee, *In the Matter of: Federal Perspectives on Access Charge Reform, A Staff Analysis*, dated September 23, 1993. Tables 1 and 2 in these comments provide the results of a survey conducted by Economics and Technology, Inc. (ETI) in 1991 of intrastate toll and switched access charges, respectively. Table 3 summarizes per-access line cost by LEC, reflecting nearly a 2-to-1 variation between the highest and lowest cost jurisdictions.

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conditions or to variations in LEC efficiency. Unfortunately, the separations process allows both possibilities to drive costs that flow into the federal jurisdiction for average, nationwide recovery. Inefficiencies present in one part of the country are thus transferred elsewhere through the separations-based cost-sharing process.

Existing traffic-sensitive cost assignment problems

While NTS separations assignments are indisputably arbitrary, there is an *apparent* economic basis for assigning traffic-sensitive (TS) costs between the federal and state jurisdictions. Specifically, TS costs are assigned according to a formula that is driven by relative use. However, toll use is weighted more heavily than local use and, since (by definition) all use that is assigned to the interstate jurisdiction is necessarily toll,⁴⁷ the *effect* is to assign disproportionate weight to interstate use relative to total use. The Task Force Report notes that 25% of TS costs are assigned to the interstate jurisdiction; whereas only 14% of total Dial Equipment Minutes (DEMs) are in the interstate category.

Ignoring (for the moment) the disproportionate weighting of interstate usage, the seemingly economic basis for jurisdictional assignment itself might be questioned since the process is rooted in average, fully-distributed cost rather than in the incremental cost of carrying additional traffic on the public network. Thus, if interstate use grows faster than intrastate (due, for example, to the demand-stimulating effects of the FCC's rate rebalancing policy), the interstate allocation will increase roughly in proportion to the growth in interstate use. The problem is that so-called traffic-sensitive costs actually do not vary in direct proportion to the volume of traffic; indeed, they increase at a significantly *slower* rate due to both the presence of substantial economies of scale and the deployment of technology featuring generally decreasing cost.⁴⁸ As such, growth in interstate use stimulates only a small change (increment) in interstate traffic-sensitive cost, yet has the effect of transferring substantially more costs out of the state jurisdiction and into the interstate column. Interestingly, as more and more states adopt and implement their own rate rebalancing programs, this process will likely reverse, and the potential for TS cost shifts back to the states will have to be anticipated.

47. Interstate local use, such as local calling among the DC, Northern Virginia and Suburban Maryland portions of the Washington, DC metropolitan area, is regulated at the state level and is considered for separations purposes to be intrastate use.

48. Optimal Peak-Load Pricing for Local Telephone Calls, Rolla Edward Park and Bridger M. Mitchell, The Rand Corporation, Publication No. R-3404-1-RC, March, 1987.

*Problems inherent in the level of revenue requirement
assigned to the interstate jurisdiction*

While there is near-unanimous agreement that the separations *mechanism* needs to be fixed, not everyone supports the position that the overall *level* of costs that has been assigned to the interstate jurisdiction is excessive. The Ad Hoc Committee has for some time believed that, at a minimum, the allocation of *traffic-sensitive* costs to the interstate jurisdiction is disproportionately high with respect to relative *usage* of TS plant (see footnote 12 *supra*). The fundamental correctness of the Ad Hoc Committee's position has recently been confirmed by the creation of the so-called "residual interconnection charge" ("RIC") following the restructure of local transport charges. In that situation, the replacement of usage-sensitive "common" transport charges with (presumably cost-based) fixed "dedicated" transport charges, involving no modification in the physical service arrangement itself, resulted in a substantial revenue shortfall that was recovered through the new RIC rate element, which by itself is not associated with any specific cost source.

In its *Comments* in CC Docket 89-79, the *ONA Access Charge Investigation*, the Ad Hoc Committee advanced the general principle that separations and jurisdictional cost assignment issues *should be transparent* with respect to access services pricing policies. The Committee noted that the disproportionate assignment of costs to the interstate jurisdiction was fundamentally at odds with the Commission's long-stated goal of achieving economically efficient cost-based prices for interstate services. The Committee urged the Commission to develop jurisdictionally neutral access charges and then to adjust the separations rules to accommodate the resulting cost-based price levels.⁴⁹ The Commission, however, did not adopt that particular recommendation.⁵⁰

Despite the Ad Hoc Committee's now-validated position that the a portion of the present interstate cost allocation should shifted to the states, any proposal to change the *level* of costs assigned to the interstate jurisdiction is likely to engender substantial controversy at a *political* level and thus run the risk of diverting the Commission's attention from important matter of achieving an efficient pricing policy overall. There are, however, alternative methods for moving toward a more efficient rate structure without shifting costs into the state jurisdiction. The key to this approach is to disconnect the

49. See generally, Comments of Ad hoc Telecommunications Users Committee and Attachment, "Efficient Pricing For ONA Access; Recommendations for Modifications to Part 69 of the FCC's Rules to Accommodate an Open Network Architecture," filed August 10, 1989.

50. See Amendment of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture; Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Order on Further Reconsideration and Supplemental Notice of Proposed Rulemaking, CC Docket Nos. 89-79 and 87-313, 6 FCC Rcd 4524 (1991) (*Part 69/ONA Order*), modified on recon., 7 FCC Rcd 5235 (1992).

political matter of aggregate jurisdictional cost assignment from the *economic* goal of efficient and cost-based pricing.

The *JTM* approach developed by the Ad Hoc Committee accomplishes precisely this result by assigning a predetermined share of total (unseparated) costs to the interstate jurisdiction as a single lump sum, not driven by specific service quantities, cost classifications, relative usage levels, or any other factors pertinent to pricing policy. Under *JTM*, modifications to pricing rules, changes in relative or absolute usage levels, reconfiguration of network components, or any other actions will have no effect whatsoever upon the proportion of costs assigned to the respective jurisdictions. Policymakers are thus free to consider and to adopt pricing changes that can improve overall efficiency, stimulate additional consumption, and provide other benefits, without concern for the "separations implications" of their actions. While the *JTM* assignments are de-linked from pricing, demand and usage, the jurisdictional cost assignments are by no means cast in stone for all time: In the event that a decision is made to alter the overall allocation, the *JTM* proposal provides for such changes in a straightforward manner through the use of a simple indexing mechanism.

Overall goals for separations reform

The basic goal of separations reform should be to create a jurisdictionally transparent system that promotes efficient and consistent pricing, rather than arbitrarily assigning jurisdictional responsibility for pricing decisions or constraining *economic* pricing policies by arbitrary cost classifications. The existing separations system should be reformed to reflect current technology and cost conditions, industry structure, and the presence of competition, and be sufficiently robust so as to withstand further developments in these areas. At the same time, to the extent that separations policy is motivated by specific social policy goals, the rules should embrace all network services providers while stopping short of transferring inefficiencies in one provider category into other (often rival) sectors. Ultimately, separations policy should be approached from the standpoint of the desired result and viewed as a system of revenue transfers as proposed in the Ad Hoc Committee's *JTM* plan. The Committee believes that a separations methodology can — and should — support each and all of the following specific policy goals:

- *Universal service*, assuring targeted assistance mechanisms for LECs exhibiting unusually high cost *due to environmental factors* (and not due to LEC inefficiencies) and for customers with limited ability to pay for basic network connectivity;
- *Broad geographic rate averaging*, reflecting the decreasing importance of distance as a cost driver;

- *Innovation and the development of specialized services*, by not encumbering new market entrants with overly burdensome contribution and/or assistance requirements, while establishing equitable levels of participation in legitimate assistance programs for all competing providers;
- *Prevention of transfer of inefficiencies* from dominant LECs to non-dominant competitors through static, accounting-based separations cost assignment rules; and
- *Efficient pricing* at both the state and federal levels.

*An affirmative proposal for reform of separations:
the Jurisdictional Transfer Mechanism (JTM)*

In the same way that separations has driven the existing access charge rules, the process of separations reform should be structured so as to facilitate access charge reform. The Ad Hoc Committee believes that resolution of basic jurisdictional separations reform issues must proceed concurrently with broader access reform initiatives. The first step in separations reform is to correct the separations *mechanism* itself. At the same time, initial steps can be taken to sever the structural ties between separations and access charge rate design in those areas where the aggregate jurisdictional revenue allocations are not materially affected. This permits these two essential activities — separations reform and access charge reform — to go forward on separate, albeit not entirely independent, tracks. Once separations reform is completed, policy assessments can then be made and implemented as to the appropriate *level* of revenue requirement allocation, and the (then reformed) access charge pricing scheme can be modified incrementally as needed. The *JTM* approach achieves the first necessary step, and provides a mechanism for easily implementing changes resulting from the second step when and if the need to do so arises.

The necessity for jurisdictional separations reform is apparent in the current system, which is not amenable to incremental "repairs." Past attempts to remedy jurisdictional separations problems have been little more than "quick fixes" with an eye toward the bottom line effects of any revisions. The *JTM* approach focuses on the *political* aspects of jurisdictional separations, which is the cornerstone of the shared federal-state regulatory responsibility, including those involving access charges. *JTM* concentrates on the *end results* of the cost allocation process rather than on the minutia associated with jurisdictional assignment procedures or the underlying methodology. The focus is the attainment of an *annual interstate revenue target* for each LEC, not a multiplicity of allocation factors that add meaningless precision to the cost separation process.

JTM is simply a new separations *mechanism*: It does not, in and of itself, affect the *level* of costs attributed to each jurisdiction. *JTM*'s benefit is its ability to separate specific

policy issues from the established transfer values. Some longer term future cost allocation issues undoubtably will require *de novo* policy reviews by future regulators.

Long term objectives of the JTM approach

JTM offers both state and federal regulators an opportunity to address the infirmities of current separations practices through an alternative that has simplicity, predictability, stability and ease of analysis among its attributes. A *JTM* plan would remove any embedded policy constraints imposed by existing separations rules. Hence, in the absence of encumbrances imposed by certain separations practices, all participants can more freely address regulatory issues for which jurisdictional separations is the foundation.

JTM has been designed to recognize and build upon the strengths of both federal and state regulators. One of the difficulties facing the FCC is the inability to establish detailed, carrier-specific cost allocation and pricing rules, because uniformity is a necessity in the interstate environment. This problem is simpler for state regulators, who are necessarily closer to their constituencies, are more politically responsive, have greater local knowledge, and who are able to focus more intensively upon the relatively small number of significant carriers within their respective jurisdictions. This allows state regulators to be inherently better equipped to work out the details of cost allocation. Conversely, states either individually or as regional groups are, virtually by definition, not capable of ensuring national uniformity and ubiquity of services. State difficulties in this area will become more severe in the future as more new, advanced telecommunications services depend critically upon nationwide connectivity. The FCC (and the existing transfer mechanism of Part 36) has more efficiently administered these types of requirements, both technically (Part 68) and economically; for example, through nationally averaged direct distance dialing rates.

Although its direct and more effective approach represents a dramatic departure from existing separations methodology, *JTM* is fully compatible with state and federal commitments to universal service and is consistent with the requirements of *Smith v. Illinois Bell*.⁵¹ Thus, *Smith* does not mandate use of specific separations procedures, but provides that "extreme nicety is not required, only reasonable measures being essential."⁵²

51. 282 US 133 (1930).

52. *Id.* at 150. See also, *National Association of Regulatory Utility Commissioners v. FCC*, 737 F.2d 1095 (D.C. Cir. 1984) (stating, "*Smith*, dealt with jurisdiction ... [and] did not address the manner in which the federal agency was to perform its task"); *MCI Telecommunications Corp. v. FCC*, 750 F.2d 135 (D.C. Cir. 1984) (stating, "*Smith* does not compel the use of any particular formula ..., it compels only reasonable measures.").